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Proposed statement of position : reporting by financial institutions of debt securities held as assets;Reporting by financial institutions of debt securities held as assets; Exposure draft (American Institute of Certified Public Accountants), 1990, May 25

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

REPORTING BY FINANCIAL INSTITUTIONS OF DEBT SECURITIES HELD AS ASSETS

MAY 25, 1990

Prepared by the Accounting Standards Executive Committee
Accounting Standards Division
American Institute of Certified Public Accountants

Comments should be received by August 1, 1990, and addressed to
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SUMMARY

This proposed statement of position (SOP) provides guidance on applying generally accepted accounting principles in reporting by financial institutions of debt securities held as assets. Briefly, the proposed SOP recommends the following:

- A financial institution should designate debt securities held as assets as investments, assets held for sale, or trading assets at acquisition and at each subsequent balance sheet date.
- A financial institution should designate debt securities as investments and report them at amortized cost only if it currently has the ability to hold the securities to maturity and it intends to hold them for the foreseeable future, as defined in this exposure draft.
- Debt securities that do not meet the criteria for classification as investments and that are not trading assets should be reported in a separate asset category as assets held for sale at the lower of their amortized cost or market value.
- A decline in value of debt securities that is other than temporary should be reported as a realized loss and should result in reducing the reported amount of the debt securities to a new historical cost basis.

The provisions of this proposed Statement would be effective for financial statements for periods ending on or after December 15, 1990.

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May 25, 1990

Accompanying this letter is an exposure draft of a proposed statement of position (SOP), Reporting by Financial Institutions of Debt Securities Held as Assets, and its summary.

The purpose of the exposure draft is to solicit comments from representatives of financial institutions, users of financial institutions' financial statements, and other interested parties. The proposed SOP is an amendment to the following AICPA industry audit and accounting guides and statement of position:

- Audits of Banks
- Audits of Credit Unions
- Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)
- Audits of Fire and Casualty Insurance Companies
- Savings and Loan Associations
- Audits of Stock Life Insurance Companies
- SOP 86-1, Reporting Repurchase-Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations, paragraphs 31(a)(2) and 31(b)

The discussions that led to this exposure draft indicated that few would disagree that under current generally accepted accounting principles, a financial institution should report debt securities at their amortized cost if it has the ability and the intent to hold them to maturity. Many believe that underlying that basis of reporting is the notion that no writedown to lower of cost or market is necessary in such circumstances, because, in the absence of credit concerns, a financial institution can expect to recover the amortized cost of debt securities through sale, if market values recover, or at maturity.

In practice, however, it is difficult to assess intent to hold debt securities. Consequently, many financial institutions report such securities as investments simply when they have no intent to sell them. Under the provisions of this exposure draft, a mere absence of intent to sell is not equivalent to an intent to hold, and it is an insufficient basis for avoiding a writedown to market value. As a practical solution to the difficulty of assessing intent to hold to maturity, this exposure draft would require an intent to hold for the foreseeable future, as it defines that term, thereby substituting for the period to maturity a series of periods that are more readily susceptible to evaluation.

The Financial Accounting Standards Board (FASB) has suggested that the Accounting Standards Executive Committee (AcSEC) consider adding conforming mortgage loans that could be packaged as passthrough certificates to the scope of the document. Accordingly, the definition in the final SOP of a debt security could be broadened to include such loans or to include all originated loans. Comments or suggestions on any aspect of this exposure draft will be appreciated. However, respondents are specifically requested to provide comments on this issue.

It will be helpful if respondents refer to specific paragraph numbers and include reasons for any suggestions or comments.

Comments on the exposure draft should be sent to Frederick Gill, Technical Manager, Accounting Standards Division, File 4310.TI, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by August 1, 1990.

Written comments on this exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA's offices for one year after August 31, 1990.

Yours truly,

John L Kreischer

John L. Kreischer, Chairman
Accounting Standards
Executive Committee

Accounting Standards Executive Committee
(1989-1990)

AcSEC gratefully acknowledges the contributions of members of the Task Force on Investment vs. Trading, who prepared earlier drafts of this document.

Task Force on Investment vs. Trading

REPORTING BY FINANCIAL INSTITUTIONS OF DEBT SECURITIES HELD AS ASSETS

SCOPE

1. This proposed statement of position (SOP) provides guidance for financial reporting of debt securities held as assets by financial institutions that use the historical cost basis of reporting investment assets, including banks, savings and loan associations, credit unions, finance companies, and insurance companies. Other reporting entities that have subsidiaries or investees accounted for by the equity method to which this proposed SOP applies should retain the results of applying this proposed Statement in consolidated or parent company financial statements in which those entities are included.

2. Reporting of debt securities held as assets by insurance companies is addressed in Financial Accounting Standards Board (FASB) Statement No. 60, Accounting and Reporting by Insurance Enterprises. Accordingly, insurance companies should also be guided by the provisions of that Statement. FASB Statement No. 60 requires insurance companies to carry investments in debt securities at amortized cost if the insurance companies have "both the ability and the intent to hold [them] until maturity and there is no decline in the market value . . . other than a temporary decline." For insurance companies, this proposed SOP clarifies the application of those criteria and provides guidance on reporting debt securities held as assets when those criteria are not met.

3. As used in this proposed SOP, debt securities include—

- Bills, notes, and bonds issued by—
  - a. The federal, state, and local governments in the United States and agencies of those governments.
  - b. Foreign governments and agencies of those foreign governments.
- Bonds and commercial paper issued by business enterprises and not-for-profit organizations.
- Mortgage-backed and other securitized debt instruments.

Debt securities also include preferred stock that by its terms either must be redeemed by the issuing enterprise or is redeemable at the option of the investor, because, for the purposes of this proposed SOP, such preferred stock has the essential characteristics of debt. Other unsecuritized commercial and personal loans, leases, credit card receivables, real estate loans, construction loans, and automobile loans are not included in the scope of this proposed SOP.

4. The conclusions in this proposed SOP are based on the view that all financial institutions that use the historical cost basis of reporting debt securities held as investments should generally report transactions involving those assets the same way. This proposed SOP therefore provides uniform guidance on reporting debt securities held as assets. It amends the following AICPA industry audit and accounting guides and statement of position:

- Audits of Banks
- Audits of Credit Unions
- Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)
- Audits of Fire and Casualty Insurance Companies
- Savings and Loan Associations
- Audits of Stock Life Insurance Companies
- SOP 86-1, Reporting Repurchase-Reverse Repurchase Agreements and Mortgage-Backed Certificates by Savings and Loan Associations, paragraphs 31(a)(2) and 31(b)

CURRENT PRACTICE

5. Financial institutions that use the historical cost basis of reporting investment assets generally report debt securities they classify as investments at amortized cost. That manner of reporting emphasizes their acquisition costs, effective yields, and maturity amounts and ignores changes in their market prices unless such changes are other than temporary. In contrast, those financial institutions report debt securities they classify as trading assets at market prices current at the balance sheet dates.

REASONS FOR CONCERN

6. The terms investment and trading have been used in the authoritative financial reporting literature (excerpted in appendix B) to distinguish debt securities acquired for those separate purposes, but that literature has not clearly distinguished those terms. As a result, application of those distinctions in practice has been diverse. Two factors have contributed to the diversity:

a. The AICPA audit and accounting guides provide guidance for reporting debt securities that is uniform for particular industries but is inconsistent from industry to industry; thus, similar transactions may be reported differently in different industries.

b. Changes in the economic environment, deregulation of interest rates, the increased sophistication of interest rate risk management techniques, and the availability of new financial instruments used to reduce or hedge interest rate risk have resulted in increased sales of debt securities classified as investments.

7. Regulators of financial institutions have expressed concern about what they perceive as the current practice by some institutions of accounting for debt securities that are held for sale as investment assets. Activities concerning securities classified as investments that regulators consider objectionable have also contributed to those concerns. Such activities are described in the April 14, 1988, Banking Circular Selection of Securities Dealers and Unsuitable Investment Practices, which is reproduced in appendix C.

CONCLUSIONS

8. A financial institution covered by this proposed SOP should designate debt securities held as assets as investments, assets held for sale, or trading assets at acquisition and at each subsequent balance sheet date.

9. A financial institution should designate debt securities as investments and report them in a separate asset category at amortized cost only if the institution currently has the ability to hold the securities to maturity and it intends to hold them for the foreseeable future, as defined in paragraph 18 of this proposed SOP.

10. Debt securities should be designated as trading assets if they are bought and held for the purpose of selling them in the short term. Trading generally involves active and frequent buying and selling. Trading assets should be reported in a separate asset category at each balance sheet date at market prices current at that date.

11. Debt securities that do not meet the criteria in paragraph 9 and that are not trading assets should be classified and reported in a separate asset category as assets held for sale.[1] Such securities should be reported at the lower of amortized cost or market.

12. A decline in value of debt securities held as investments or as assets held for sale that is other than temporary should be reported as a realized loss and should result in reducing the reported amount of the debt securities to a new historical cost basis.

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[1] FASB Statement No. 60 specifies only two categories for reporting debt securities held as assets: investments and trading assets. This proposed SOP would establish a third category for insurance companies, assets held for sale.

13. Financial institutions other than insurance companies covered by this proposed SOP should include gains or losses reported by applying this guidance in the determination of net income. Insurance companies should follow the guidance in FASB Statement No. 60 in reporting such gains and losses.

Disclosure

14. The market values and the aggregate amounts of both (a) unrealized gains and (b) unrealized losses should be disclosed separately for debt securities reported as investments and for debt securities reported as assets held for sale.

IMPLEMENTING THE CONCLUSIONS

Ability to Hold to Maturity

15. An institution should consider whether there are factors that may impair its ability to hold debt securities to maturity. In the absence of evidence to the contrary, it is reasonable to conclude that the institution currently has that ability. Examples of factors that should be considered include the following:

- o Loss of a funding source
- o An inability to satisfy liabilities in the normal course of business
- o Regulatory and legal requirements and constraints, such as a need to meet minimum capital requirements

Intent to Hold for the Foreseeable Future

16. The intent to hold debt securities for the foreseeable future required by paragraph 9 of this proposed SOP should be explicitly stated by management in the notes to the financial statements and should be supported by an evaluation of events that might be reasonably expected to cause the institution to decide to sell. If it is considered probable that those events will occur in the foreseeable future, the intent-to-hold test is not met. If the intent-to-hold test is not met, the securities should be classified as assets held for sale. The evaluation need not extend to events that are not susceptible to prudent evaluation (see paragraph 19). The evaluation should consider pertinent historical experience (see paragraph 21).

17. If an institution would sell a security or a group of securities in response to changes in levels of interest rates, it should identify those rate levels that might be reasonably expected to cause it to decide to sell. For such securities to be classified as investment assets, the institution must conclude that it is not probable that interest rates will change to the identified levels within the next twelve months.

18. The Foreseeable Future. For the purposes of this proposed SOP, the foreseeable future is generally the period ending one year after the balance sheet date. However, certain events that are currently expected to take place beyond twelve months, such as those resulting from a strategy to sell certain assets in light of capital requirements, liquidity needs, or operating decisions, are considered part of the foreseeable future.

19. Susceptible to Prudent Evaluation. Events that are susceptible to prudent evaluation are, for purposes of this proposed SOP, generally those that could reasonably be anticipated, evaluated, and addressed before the events occur. For example, a need to sell some assets over the next year in response to known capital requirements or identified liquidity needs usually would be susceptible to such evaluation.

20. Other events usually cannot be anticipated, evaluated, and addressed before the events occur. Changes in regulatory requirements or tax legislation, for example, may not be susceptible to prudent evaluation. Management should gather sufficient information on a timely basis to evaluate such events once they have occurred and to determine what actions, if any, need to be taken and what effect these events have on the intent to hold debt securities.

21. Pertinent Historical Experience. If debt securities designated as investments are sold or transferred,[2] the institution should consider whether, in the light of such sales or transfers, similar debt securities should be classified as investments in current and subsequent financial statements. A recent pattern of sales or transfers may be inconsistent with an expressed current intent to hold similar debt securities, particularly if unrecognized losses remain in the investment in debt securities account after sales of selected similar securities at a gain.

22. Management must apply judgment in determining which debt securities are similar. However, in applying that judgment, debt securities should be considered similar if they have the same significant economic characteristics, for example, fixed or floating interest rates, borrowers' prepayment options, or presence or absence of collateral. Categories should be consistent from period to period. Also, the number of categories of debt securities considered similar should not be so large that insignificant characteristics differentiate economically similar debt securities.

[2] As debt securities approach maturity, their market prices tend to approach their maturity amounts less interest and a factor for credit risk, and market risk diminishes as a factor in their pricing. For purposes of this proposed SOP, securities that are sold at maturity or near enough to maturity that market risk is substantially eliminated as a pricing factor should be considered in-substance held to maturity.

REPORTING DEBT SECURITIES

Reporting Methods

23. FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities, paragraph 5, states that purchase discounts on mortgage loans and mortgage-backed securities should not be amortized during the periods the loans or securities are held for sale. However, FASB Statement No. 65 addresses mortgage banking activities, in which the holding periods are typically short. When an institution not conducting mortgage banking activities designates debt securities as held for sale and anticipates holding those securities, purchase premiums or discounts should be amortized in accordance with FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.

24. Aggregations of debt securities should be based on their pertinent characteristics for the purpose of determining the lower of their amortized cost or market value. Those aggregations should be applied consistently from period to period. In consolidated financial statements, the lower of cost or market method should be based on pertinent aggregations for all entities included in those financial statements to which this proposed SOP applies.

25. A reduction in the carrying amount of debt securities held for sale to the lower of amortized cost or market is reported by means of a valuation allowance and, except for insurance companies, by a corresponding charge to income. Such reductions should not be amortized back into income as time elapses. However, if market values recover, the valuation allowance would be reduced, in effect writing the debt securities up to the lower of amortized cost or current market.

Transfers Among Classifications

26. Debt securities may be transferred from investments to assets held for sale. The securities should be transferred at amortized cost, and the lower of cost or market method should be applied immediately. If a certain dollar amount of debt securities needs to be transferred but specific securities cannot be designated for transfer, an appropriate portion of the amortized cost of the institution's debt securities treated as investments should be transferred to the assets held for sale account. In such cases, the market value assigned to that amortized cost should be based on the relationship of amortized cost and market value of total debt securities designated as investments prior to the transfer. When specific securities are subsequently designated as held for sale, they should be transferred to the assets held for sale account at amortized cost on the date of transfer, and a related portion of the assigned market value should be replaced by the market value of the specific securities.

27. Debt securities may be transferred from assets held for sale to investments. The securities should be transferred at the lower of amortized cost or market value at the date of transfer. If market value is less than amortized cost, the market value then becomes the new cost basis.

28. Debt securities may be transferred to or from trading assets; however, transfers to trading assets should be rare. The securities should be transferred at market value at the date of transfer, and the market value should become the new cost basis for the securities. No gain should be recognized on such transfers; the amount by which such securities are written up, if any, should be deferred until final disposition of the securities.

Presentation in the Statement of Cash Flows

29. Cash flows from purchases, sales, and maturities of securities designated as assets held for sale should be classified as cash flows from investing activities and reported gross in the statement of cash flows.

EFFECTIVE DATE AND TRANSITION

30. This proposed SOP should be applied to all debt securities in financial statements for periods ending on or after December 15, 1990. For many financial institutions, adoption of this proposed SOP will result in a change in accounting principle. The nature of the change in accounting principle should be disclosed in the financial statements of the period in which the change is made. However, no cumulative effect of a change in accounting principle, and no restatement of previously issued financial statements, will arise as a result of applying this proposed SOP.

ILLUSTRATIONS OF THE APPLICATION OF PARAGRAPH 26

Illustration 1

X has the following portfolio of debt securities classified as investments on December 31, 19X1:

	Amortized Cost	Market Value
Treasury bills	$ 5,000,000	$ 5,000,000
Municipality A bonds	5,000,000	4,500,000
Municipality B bonds	1,200,000	1,200,000
Total	$11,200,000	$10,700,000

X expects to sell in the foreseeable future 10 percent of its securities classified as investments. However, X is unable to determine which securities it would sell. X should transfer $1,120,000 from its investments account to its assets held for sale account. The market value assigned to the amount transferred to the assets held for sale account is computed as follows:

$$\frac{\text{Amortized cost transferred}}{\text{Total amortized cost prior to transfer}} \times \text{Total market value prior to transfer} = \text{Market value of amount transferred}$$

$$\frac{\$1,120,000}{\$11,200,000} \times \$10,700,000 = \$1,070,000$$

X subsequently designates for sale a portion of Municipality A bonds with an amortized cost of $1,120,000. X would transfer those securities to the assets held for sale account at amortized cost and replace the assigned market value with the market value of those securities.

Illustration 2

Y has the same portfolio of debt securities classified as investments on December 31, 19X1, as X. An evaluation of the events that might be reasonably expected to cause Y to decide to sell debt securities leads to a conclusion that it is probable that events will occur that would cause Y to sell debt securities with a market value of $1,000,000. However, Y is unable to determine which securities it would sell. Y should transfer $1,046,729 from its investment account to its assets held for sale account. The amount transferred is computed as follows:

$$\frac{\text{Market value to be sold}}{\text{Total market value prior to transfer}} \times \text{Total amortized cost prior to transfer} = \text{Amortized cost to be transferred}$$

$$\frac{\$1,000,000}{\$10,700,000} \times \$11,200,000 = \$1,046,729$$

The market value assigned to the amount transferred is $1,000,000.

EXCERPTS OF AUTHORITATIVE ACCOUNTING AND AUDITING LITERATURE

Criteria for classifying debt securities as investments and reporting them at amortized cost are addressed in FASB Statement No. 65, Accounting for Certain Mortgage Banking Activities. Paragraph 6 of that Statement states:

> A mortgage loan or mortgage-backed security shall not be classified as a long-term investment unless the mortgage banking enterprise has both the ability and the intent to hold the loan or security for the foreseeable future or until maturity. [Emphasis added.]

In contrast, paragraph 12 of FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, states:

> Accounting for investments by insurance enterprises presumes that (a) insurance enterprises have both the ability and the intent to hold long-term investments, such as bonds, mortgage loans, and redeemable preferred stocks, to maturity.... [Emphasis added.]

The AICPA Industry Audit Guide Audits of Banks states on page 30:

> If the debt obligations of others are held to maturity, they will generally be redeemed at face value; therefore, they are carried at cost. If they have the ability and intent to hold these securities on a long-term basis, banks do not customarily provide for unrealized declines in their value resulting from interest rate fluctuations. [Emphasis added.]

Similarly, the AICPA Industry Audit Guide Audits of Credit Unions states on page 21:

> If investment securities are held to maturity, they will generally be redeemed at face value; therefore, they are carried at amortized cost. If credit unions have the ability and intent to hold these securities on a long-term basis, credit unions do not customarily provide for unrealized declines in their value resulting from interest rate fluctuations. [Emphasis added.]

However, the AICPA Audit and Accounting Guide Savings and Loan Associations provides little guidance on classifying debt securities as investments:

> Securities may be held for investment or, in certain instances, in a trading portfolio. [page 19]

The AICPA Professional Standards states the following in volume 1, AU section 9332, "Long Term Investments: Auditing Interpretations of AU Section 332," paragraph .10:

> For investments in bonds and other investments with fixed maturity amounts, market declines may be considered temporary unless the evidence indicates that such investments will be disposed of before they mature or that they may not be realizable. [Emphasis added.]

All three guides address the possibility that debt securities that are not trading assets will not be held for a period consistent with the criteria for classifying debt securities as investments and reporting them at amortized cost. Audits of Banks states on page 30:

> It may be necessary to dispose of securities in the foreseeable future to meet the bank's investment objectives or other operational needs. An allowance for estimated losses should be established to provide for a decline in value of these securities, for example, if bank management intends to dispose of a part of its investment securities portfolio in the foreseeable future or the bank is unable to hold a significant portion of its investment portfolio. [Emphasis added.]

Similarly, Audits of Credit Unions states on pages 21 and 22:

> . . . because it may be necessary to dispose of securities in the foreseeable future to meet the credit union's investment objectives or other operational needs, an allowance for estimated losses should be established to provide for a decline in the securities' value if (a) credit union management intends to dispose of a part of its investment securities portfolio in the foreseeable future or (b) the credit union is unable to hold a portion of its investment portfolio to maturity. [Emphasis added.]

Savings and Loan Associations states on page 21:

> Since changes in the market price . . . are usually related to fluctuations in interest rates, no allowance for a decline ordinarily is necessary if management intends to and has the ability to hold the securities to maturity. [Emphasis added.]

BANKING CIRCULAR—SELECTION OF SECURITIES DEALERS AND UNSUITABLE INVESTMENT PRACTICES

PURPOSE

This issuance is to provide you with recommended procedures to be employed by all national banks when selecting securities dealers and to advise you of certain securities activities that the depository institution regulators view as unsuitable in an investment portfolio. The Federal Financial Institution Examination Council (FFIEC) recently endorsed the same policy statement. Adoption of the FFIEC policy is intended to achieve uniform and effective supervision by depository institution investment portfolio managers. The following is the text of the policy statement.

BACKGROUND

The depository institution regulators have become aware of speculative activity which has taken place in a number of depository institutions' investment portfolios. Certain of these institutions have failed because of the speculative activities, and other institutions have been weakened significantly as their earnings and capital have been impaired and the liquidity of their securities has been eroded by the depreciation in their market value.

Speculative activity often occurs when a depository institution's investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

RECOMMENDATIONS CONCERNING THE SELECTION OF A SECURITIES DEALER

It is common for the investment portfolio managers of many depository institutions to rely on the expertise and advice of a securities sales representative for: recommendations of proposed investments; investment strategies; and the timing and pricing of securities transactions. Accordingly, it is important for the management of depository institutions to know the securities firms and the personnel with whom they deal. An investment portfolio manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely

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[Ed. Note: This banking circular was distributed by the comptroller of the currency on April 14, 1988, to chief executive officers of all national banks, deputy comptrollers, and all examining personnel.]

disclosure of its financial condition. Management must review the dealer's financial statements and make a judgment about the ability of the dealer to honor its commitments. An inquiry into the general reputation of the dealer also is necessary.

The board of directors and/or an appropriate board committee should review and approve a list of securities firms with whom the depository's management is authorized to do business. The following securities dealer selection standards are recommended, but are not all inclusive. The dealer selection process should include:

- A consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.;

- an inquiry into the dealer's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current financial institution customers of the securities dealer;

- an inquiry of appropriate State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel;

- an inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise;

- a determination whether the depository institution has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) the board is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors, or a committee of the board, for unsecured transactions (see FFIEC Policy Statement adopted October 1985). Federal credit unions, when entering into a repurchase agreement with a broker/dealer, are not permitted to maintain the collateral with the broker/dealer, reference part 703 of the National Credit Union Administration rules and regulations.

As part of the process of managing a depository institution's relationships with securities dealers the board of directors may wish to consider including in the financial institution's code of ethics or code of conduct a prohibition by those employees, who are directly involved in purchasing and selling securities for the depository institution, from engaging in personal securities transactions with the same securities firm that the depository institution uses for its transactions without specific board approval and periodic review. The board also may wish to adopt a policy applicable to directors, officers or employees concerning the receipt of gifts, gratuities or travel expenses from approved dealer firms and their personnel (also see in this connection the Bank Bribery Law, 18 USC 215 and interpretive releases).

OBJECTIONABLE INVESTMENT PRACTICES

Depository institution directors are responsible for prudent administration of investments in securities. An investment portfolio traditionally has been maintained by a depository institution to provide earnings, liquidity and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of investment activities and should be conducted in a securities trading account. Securities trading of the types described in section I of the attached appendix will be viewed as unsuitable activities when they are conducted in a depository institution's investment account. Securities trading should take place only in a closely supervised trading account and be undertaken only by institutions that have strong capital and current earnings positions. Acquisitions of the various forms of zero coupon, stripped obligations and asset-backed securities residuals discussed in section II of the attached appendix will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a depository institution.

State chartered financial institutions are cautioned that certain of the investment practices listed in the appendix may violate state law. If any such practices are contemplated, the appropriate state supervisor should be consulted regarding permissibility under state law.

Appendix to FFIEC Supervisory Policy Statement on the Selection of Securities Dealers and Unsuitable Investment Practices

I. TRADING IN THE INVESTMENT PORTFOLIO

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the depository institution's income and a filing of false regulatory reports and other published financial data. It is an unsafe and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards which are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts should be marked to market, or the lower of cost or market, periodically with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the depository.

The following practices are considered to be unsuitable when they occur in a depository institution's investment portfolio.

A. "Gains Trading"

"Gains trading" is a securities trading activity conducted in an investment portfolio, often termed "active portfolio management." "Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within several days or weeks. Those securities initially purchased with the intent to resell are retained as investment portfolio assets if they cannot be sold at a profit. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold. "Gains trading" often results in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity.

In many cases, "gains trading" has involved the trading of "when-issued" securities and "pair-offs" or "corporate settlements" because the extended settlement period associated with these practices allows speculators the opportunity for substantial price changes to occur before payment for the securities is due.

B. "When-Issued" Securities Trading

"When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it. Frequent purchases and sales of securities during the "when-issued" period generally are indications of trading activity and should not be conducted in a bank's investment portfolio.

C. "Pair-Offs"

A "pair-off" is a security purchase transaction which is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will commit to purchase a security; then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price. Like "when-issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities.

D. Corporate Settlement on U.S. Government and Federal Agency Securities Purchases

Regular-way settlement for transactions in U.S. Government and Federal agency securities is one business day after the trade date. Regular-way settlement for corporate securities is five business days after the trade date. The use of a corporate settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser.

E. Repositioning Repurchase Agreements

Dealers who encourage speculation through the use of "pair-off," "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities which cannot be sold at a profit. The buyer purchasing the security pays the dealer a small "margin" that is equivalent roughly to the actual loss in the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate source funds, the purchaser acquires all the risks of ownership of a large amount of depreciated securities for a very small margin payment. Purchasing securities in these circumstances is inherently speculative and is a wholly unsuitable investment practice for depository institutions.

F. Short Sales

A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on the fall in the price of the security. Short sales are speculative transactions that should be conducted in a trading account, and when conducted in the investment portfolio, they are considered to be unsuitable.

Short sales are not permissible activities for Federal credit unions.

II. STRIPPED MORTGAGE BACKED SECURITIES, RESIDUALS AND ZERO COUPON BONDS

There are advantages and disadvantages in owning these products. A depository institution must consider the liquidity, marketability, pledgeability, and price volatility of each of these products prior to investing in them. It may be unsuitable for a depository institution to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals and zero coupon bonds which fluctuate greatly in price.

A. Stripped Mortgage Backed Securities (SMBS) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100% of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100% of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and similar instruments held by a depository institution. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for the vast majority of depository institutions. SMBS, however, may be appropriate holdings for depository institutions that have highly sophisticated and well-managed securities portfolios, mortgage portfolios or mortgage banking functions. In such depository institutions, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by the institution's board of directors and vigorously enforced.

In those depository institutions that prepare their published financial statements in accordance with Generally Accepted Accounting Principles, SMBS holdings must be accounted for in accordance with Financial Accounting Standards Board Statement #91 (FAS #91) which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other institutions may account for their SMBS holdings under FAS #91 or alternatively at market value or the lower of cost or market value.

Several states have adopted, or are considering, regulations that prohibit state chartered banks from purchasing IO strips. Accordingly, state chartered institutions should consult with their state regulator concerning the permissibility of purchasing SMBS.

B. Asset Backed Securities (ABS) Residuals

Residuals are the excess cashflows from an ABS transaction after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments, and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the "yield" on these instruments is inversely related to their effectiveness as a risk management vehicle. In other words, the highest yielding ABS residuals have limited risk management value usually due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cashflows very difficult.

Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher "yielding" interests, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

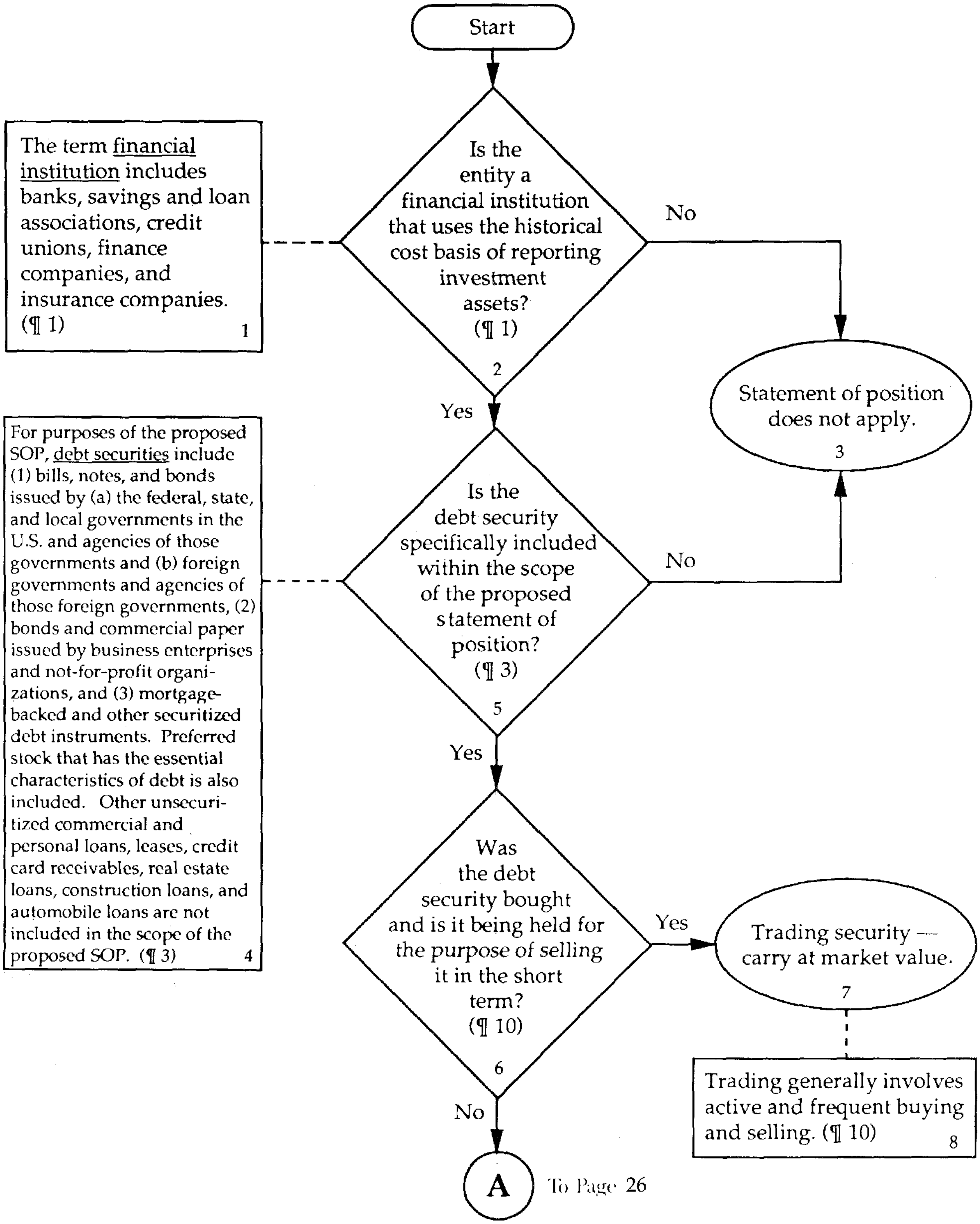
Residual interests in ABS are not permissible acquisitions for Federal credit unions. Holdings of ABS residuals by other institutions should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as "Other Assets" on regulatory reports.

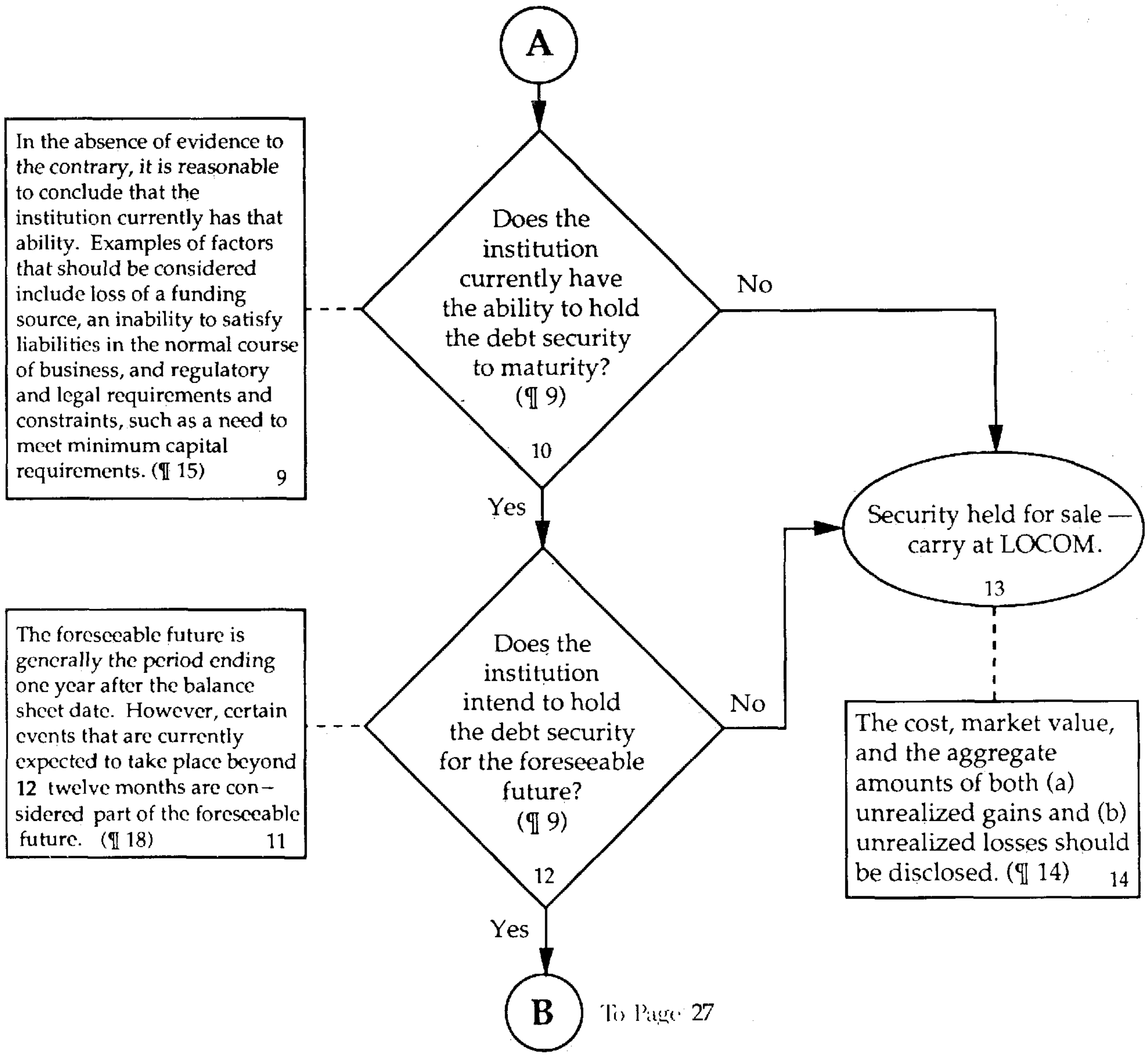
C. Other Zero Coupon or Stripped Products

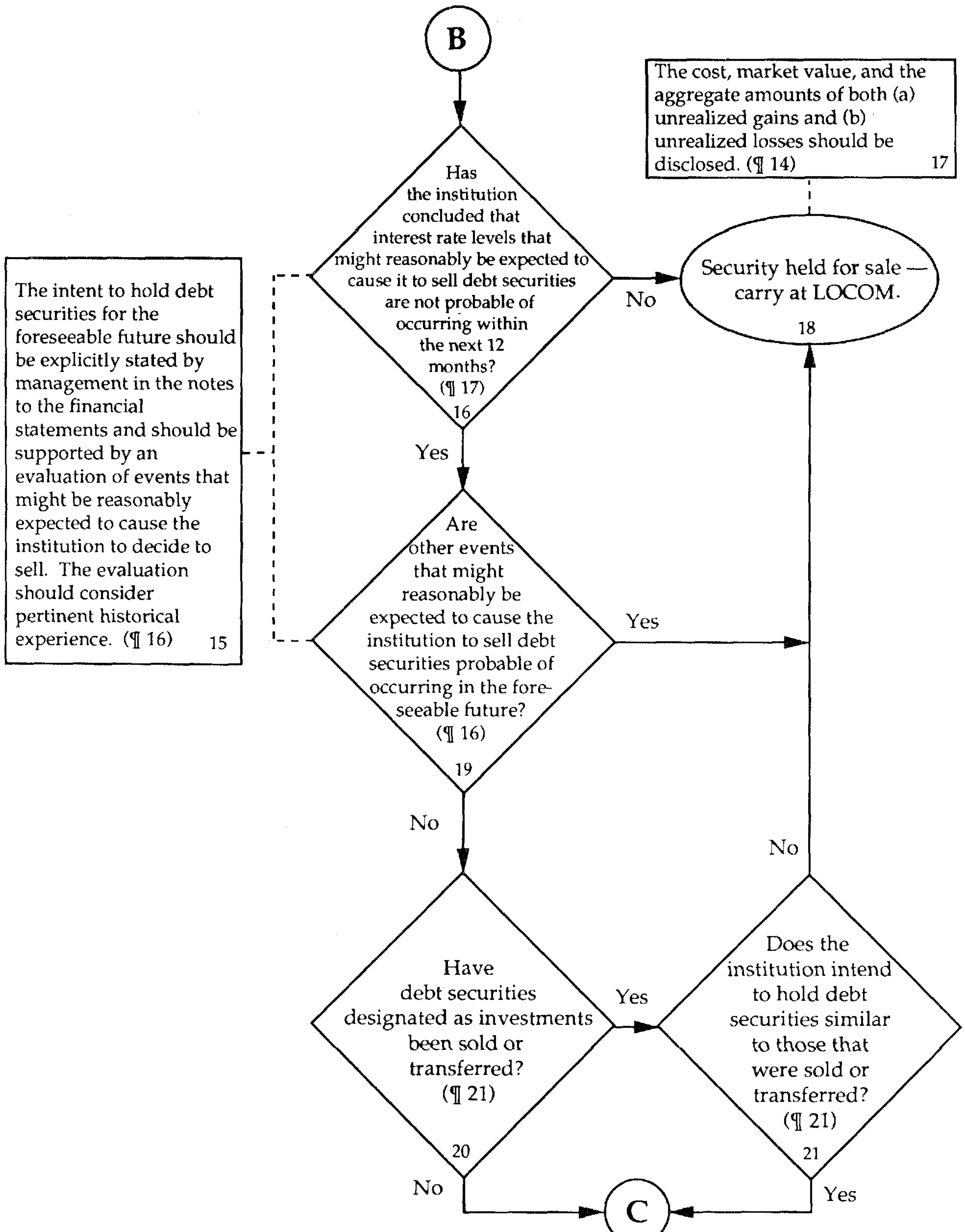
The interest and/or principal portions of U.S. Government obligations are sometimes sold to depository institutions in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATs or TIGRs. Also, Original Issue Discount Bonds (OIDs) have been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility and, accordingly, disproportionately large long-maturity holdings (in relation to the total portfolio) of zero coupon securities appear to be unsuitable for investment holdings for depository institutions.

APPENDIX D

Proposed AICPA Statement of Position
"Reporting by Financial Institutions of Debt Securities Held as Assets"




A
In the absence of evidence to the contrary, it is reasonable to conclude that the institution currently has that ability. Examples of factors that should be considered include loss of a funding source, an inability to satisfy liabilities in the normal course of business, and regulatory and legal requirements and constraints, such as a need to meet minimum capital requirements. (¶ 15) 9
Does the institution currently have the ability to hold the debt security to maturity? (¶ 9) 10
No
Yes
Security held for sale — carry at LOCOM. 13
The foreseeable future is generally the period ending one year after the balance sheet date. However, certain events that are currently expected to take place beyond 12 twelve months are considered part of the foreseeable future. (¶ 18) 11
Does the institution intend to hold the debt security for the foreseeable future? (¶ 9) 12
No
The cost, market value, and the aggregate amounts of both (a) unrealized gains and (b) unrealized losses should be disclosed. (¶ 14) 14
Yes
B
To Page 27


B
Has the institution concluded that interest rate levels that might reasonably be expected to cause it to sell debt securities are not probable of occurring within the next 12 months? (¶ 17) 16
No
Security held for sale — carry at LOCOM. 18
The cost, market value, and the aggregate amounts of both (a) unrealized gains and (b) unrealized losses should be disclosed. (¶ 14) 17
The intent to hold debt securities for the foreseeable future should be explicitly stated by management in the notes to the financial statements and should be supported by an evaluation of events that might be reasonably expected to cause the institution to decide to sell. The evaluation should consider pertinent historical experience. (¶ 16) 15
Yes
Are other events that might reasonably be expected to cause the institution to sell debt securities probable of occurring in the foreseeable future? (¶ 16) 19
Yes
No
Have debt securities designated as investments been sold or transferred? (¶ 21) 20
Yes
Does the institution intend to hold debt securities similar to those that were sold or transferred? (¶ 21) 21
No
No
Yes
C
To Page 28

C

Security held for investment — carry at amortized cost
22

The cost, market value, and the aggregate amounts of both (a) unrealized gains and (b) unrealized losses should be disclosed separately for debt securities reported as investments.
(¶ 14) 23

Transfers Among Classifications

Securities transferred from investments to assets held for sale are transferred at amortized cost. A lower of cost or market test is then immediately applied to the assets held for sale. Securities transferred from assets held for sale to investments are transferred at the lower of cost or market at the date of transfer, which becomes the new cost basis. Securities transferred to or from trading assets are transferred at market value at the date of transfer. The market value becomes the new cost basis. Any excess of market value over cost (gain) at the date of transfer is deferred until the security is sold.
(¶ 26 - 28) 24

Impairment

If there has been a decline in the value of the debt security that is other than temporary, the carrying amount of the debt security should be reduced to a new historical cost basis. The decline in value should be reported as a realized loss.
(¶ 12)
25